

# Monitoring the Trade Desk Best Execution

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## SEEKING BEST EXECUTION

- Introduction – What constitutes the “best execution”?
- Fiduciary Responsibility
- Trading and Commission Practices
- Conflicts of Interest & Disclosure
- Soft Dollars and Section 28(e)
- Establishing a Framework for Policies & Procedures
- Resources
- Questions - ???

## SO, WHAT IS “BEST EXECUTION?”

Section 28(e) - 1986 Interpretive Release No. 23170

April 23, 1986

***“As a fiduciary, a money manager has an obligation to obtain “best execution” of clients’ transactions under the circumstances of the particular transaction. The money manager must:***

***Execute securities transactions for clients in such a manner that the client’s total cost or proceeds in each transaction is the most favorable under the circumstances.”***

## WHAT IS “BEST EXECUTION”?

SEC - Information for Newly-Registered Investment Advisors

November 23, 2010

***“As an investment adviser, you are a “fiduciary” to your advisory clients. This means that you have a fundamental obligation to act in the best interests of your clients and to provide investment advice in your clients’ best interests. You owe your clients a duty of undivided loyalty and utmost good faith. You should not engage in any activity in conflict with the interest of any client, and you should take steps reasonably necessary to fulfill your obligations. You must employ reasonable care to avoid misleading clients and you must provide full and fair disclosure of all material facts to your clients and prospective clients.”***

***“Departure from this fiduciary standard may constitute “fraud” upon your clients (under Section 206 of the Advisers Act). “***

## WHAT IS “BEST EXECUTION”?

FINRA – Rule 5310

*“In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.”*

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## WHAT IS “BEST EXECUTION”?

Isn't “Best Ex” the smallest spread with the lowest commission rate? In other words, isn't it the lowest cost for the client?

- Smallest spread and lowest commission does NOT make up total cost. Implicit costs must be accounted for as well.
- “True cost” or “total cost” of an execution includes:

### **Explicit Costs**

- Commission and Fees
- Bid-Ask Spread

### **Implicit Costs**

- Market Impact
- Timing
- Opportunity Cost

## WHAT IS “BEST EXECUTION”?

What it is:

- Guidance
- Acting as a fiduciary in the best interest of the client
- Due diligence regarding trading/execution to receive the best price under market conditions
- Disclosure and Reporting of conflicts of interest to clients
- Monitoring and periodic evaluation of execution process

**Providing best quantitative AND qualitative execution for the client**

What it ISN'T:

- A legally defined term
- The lowest possible commission rate or price

## FIDUCIARY RESPONSIBILITY

- Act in the best interest of the client when transacting
- Avoid conflicts of interest
- Attempt to receive the best pricing for trades
- Disclose any unavoidable conflicts of interest
- Periodic review client transactions
- Periodic review trade policies and procedures
- Fiduciaries cannot use assets to benefit themselves

**Acting as a fiduciary = Seeking best execution**



## AM I A FIDUCIARY?

- Registered Investment Advisors (RIAs) and Investment Advisor Representatives (IARs) are fiduciaries under the Investment Advisors Act of 1940
  
- Brokers and Registered Reps are considered fiduciaries under state common law
  - Dodd-Frank allows the SEC to apply fiduciary standards on broker-dealers and their registered reps if they provide investment advice to a client
  
  - Dual Registration: Considers Registered Rep as a NON-Fiduciary regarding brokerage accounts and as a Fiduciary concerning advisory accounts.

## TRADING PRACTICES – ORDER EVALUATION

Orders should be evaluated on (but not limited to):

- Size of the order – Is the order a large % of Daily Volume?
- Trading characteristics of the security - Liquid/illiquid, penny stock/Berkshire Hathaway?
- Venue – Where is the best place to execute this order?
- Using electronic tools – Does using an algo improve execution?
- Cost of trading in a venue

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## TRADING PRACTICES – BROKER SELECTION

Brokers are evaluated over the “True Cost” of the trade including:

- Access to Liquidity
- Expertise in trading a type of security
- Systems capabilities
- Access – and avoidance – of venues
- Negotiated commission rates
- Clearing & Settlement efficiencies
- Prime brokerage services
- Financial condition and reputation of the firm
- Soft dollar services
- Overall execution cost
- Avoiding any conflict of interest...

## CONFLICTS OF INTEREST & DISCLOSURES

- Trade aggregation (blocking) & allocation policies
- Access to IPO's
- Principal vs. Agency trading
- Soft Dollars

## CONFLICTS OF INTEREST & DISCLOSURES

### Trade aggregation (blocking) & allocation policies

- Trade rotation/sequencing
- Average pricing
- No preferential treatment of orders

### Access to IPO's

- Having access to IPO can be a benefit to clients. However, access to IPO's can also be a conflict with "pay-to-play" implications

## CONFLICTS OF INTEREST & DISCLOSURES

### Principal vs. Agency trading

- Clients should not be disadvantaged pricing due to a principal trade
- You should also seek to obtain the best price and execution when you enter into transactions for clients on a “principal” or “agency cross” basis.
- If you have acted as a principal for your own account by buying securities from, or selling securities to, a client, you must disclose the arrangement and the conflicts of interest in this practice (in writing) and also obtain the client’s consent for each transaction prior to the time that the trade settles.
- There are also explicit conditions under which you may cross your advisory clients’ transactions in securities with securities transactions of others on an agency basis under Rule 206(3)-2.

## SOFT DOLLARS AND SECTION 28(E)

Section 28(e) of the Securities Exchange Act of 1934

- Bundled vs. Unbundled
- Types of Arrangements - CCA/CSA/RPA
- Brokerage & Research Providers
- Research
- Brokerage
- Mixed Use
- MiFID II
- Directed Brokerage

## SECURITIES EXCHANGE ACT OF 1934, AMENDED – JUNE 4, 1975

### Section 28(e)

- (1)** No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments in 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. This subsection is exclusive and plenary insofar as conduct is covered by the foregoing, unless otherwise expressly provided by contract: *Provided, however,* That nothing in this subsection shall be construed to impair or limit the power of the Commission under any other provision of this title or otherwise.
- (2)** A person exercising investment discretion with respect to Disclosure, an account shall make such disclosure of his policies and practices with respect to commissions that will be paid for effecting securities transactions, at such times and in such manner, as the appropriate regulatory agency, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.
- (3)** For purposes of this subsection a person provides brokerage and research services insofar as he—
- (A)** furnishes advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities;
- (B)** furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or
- (C)** effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-regulatory organization of which such person is a member or person associated



## SECTION 28(E)

1. No one with investment discretion in a transaction has acted unlawfully for paying other than the lowest rate commission available, if in good faith, it is determined that the amount of the commission is reasonable in relation to the value of the brokerage and/or research services provided by the broker.
2. Anyone exercising investment discretion is required to make full disclosure of policies and practices regarding transactions/commissions
3. A person provides brokerage and/or research services if:
  - A. Furnishes advice to the value of securities, advises in buying or selling
  - B. Furnishes reporting about securities, industries, economic factors, trends, portfolio strategy
  - C. Effects the securities transaction and performs brokerage functions (like clearing, settlement, or custody)

## SECTION 28(E)

Provides a “safe harbor” for asset managers exercising investment discretion over client accounts that receive brokerage and/or research products or services in exchange for commissions from their managed client account transactions. Qualifies when:

- Manage assets on discretionary basis
- Transact with registered broker-dealer through agency or riskless principal transactions
- Applies ONLY to research, brokerage, or mixed-use products and services
- Includes proprietary and third party research
- All commissions of discretionary accounts may be aggregated to pay for products and services

## SECTION 28(E) – TYPES OF ARRANGEMENTS

**CCA** – “Client Commission Arrangement” – SEC language giving “soft dollars” a different name, beginning 2006

**CSA (US)** – Similar to CCA but commission may be split between registered broker/dealers

**CSA (UK)**– “Commission Sharing Arrangement” - Adopted by the UK in 2005, similar to CCA in the US with some fundamental differences

**RPA** – “Research Payment Accounts” – Research Payment Accounts” – Proposed in MiFID II

## SECTION 28(E) – ALPHABET SOUP

Bundled...Unbundled... CCA...CSA...RPA....

...It's all the same:

There is no distinction between bundled commissions used to pay for proprietary sell-side research or a CSA/RPA type arrangement used to pay for third party research or brokerage service – it is ALL considered “Soft Dollars”

## SECTION 28(E) – CLIENT COMMISSION ARRANGEMENTS (CCA)

**Client Commission Arrangement (CCA)** - commonly referred to as “soft dollars”, allow an IA to execute a trade with a broker and allocate a portion of the total commission towards investment research

CCA applies to both proprietary and “third party” research arrangements. Third parties are qualified research providers but not affecting the securities transaction

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## SECTION 28(E) - COMMISSION SHARING ARRANGEMENTS (CSA - US)

CSA (Commission Sharing Arrangement) in the US allows a money manager to pay for research by allowing providers to split or share commissions IF they are registered broker/dealers AND meet the following conditions:

- IA is responsible for qualifying the research as 28(e) eligible
- Executing broker has no input on the value of the research
- Payments are made from a pool designated by the IA and broker for research services
- Payment for research does not require transaction in the securities analyzed or traded
- Research provider is paid for research services only and does not perform other broker/dealer functions

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## SECTION 28(E) – RESEARCH BROKERS

**Broker-dealers are considered “effecting” a trade if they:**

1. Execute, clear, or settle the trade
2. OR perform one of the following functions:
  - Take responsibility for customer trades
  - Maintain records relating to customer trades
  - Monitor and respond to customer comments regarding trading
  - Monitor trades and settlements

**Broker-dealers are considered research providers if they:**

- Prepare the research
- Are financially obligated to pay for the research
- Are not financially obligated to pay but arrangements have certain attributes

## SECTION 28(E) – TRANSACTIONS

### Eligible Transactions

- Agency and Riskless Principal Equity Transactions - Client commissions on agency transactions and fees on certain riskless principal transactions that are reported under NASD trade reporting rules.
- Fixed Income – The 2006 Interpretive Release indicates that a manager may use fixed income trades, on an agency basis, to generate funds for research purposes.
- Options – Options transactions based on securities, transacted on an agency basis qualify as eligible transactions under Section 28(e).

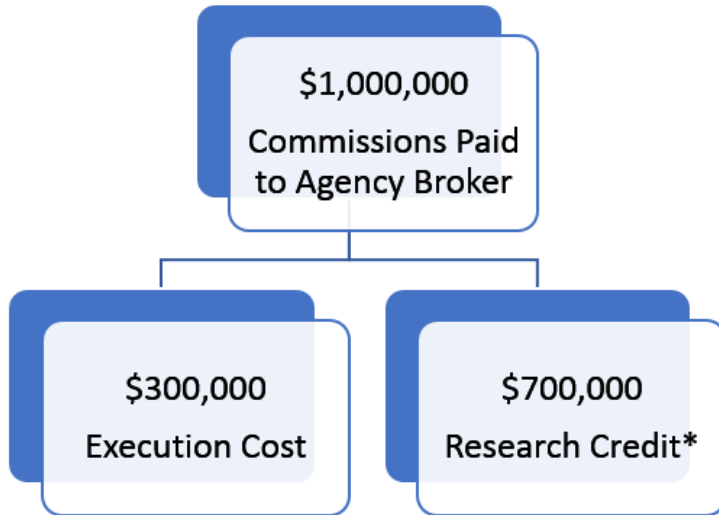
### Ineligible Transactions

- Principal Transactions
- Futures

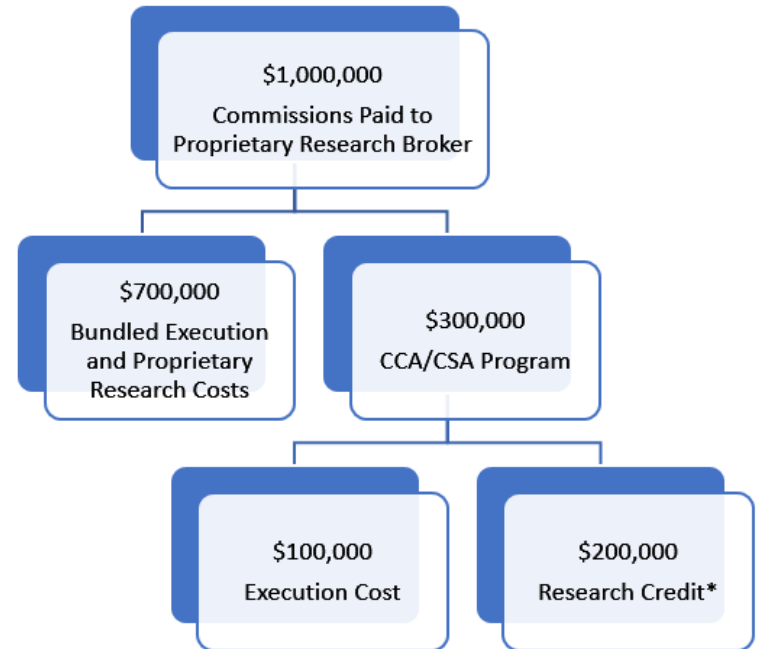


## SECTION 28(E) – AGENCY VS. PROPRIETARY

AGENCY BROKER



PROPRIETARY RESEARCH



\*Under Section 28(e), research credit generated through a soft dollar (CSA/CCA) program may be used to pay for research & brokerage services that aid in the investment decision making process. These services can be produced by third-party vendors (ex: Bloomberg, S&P) or broker/dealers who provide proprietary research.

*CAPIS Guide to Client Commission Practices Under 28(e). Used by permission.*

## SECTION 28(E) - PRODUCT & SERVICE ELIGIBILITY THREE PRONG TEST

**Three criteria to qualify a product or service eligible under 28(e):**

- 1. Eligible** - Is the product or service eligible to be considered “research” or “brokerage”?
- 2. Use** - Does the product or service provide assistance in the investment decision making process?
- 3. Value** - Has the money manager, in good faith, determined the amount of commissions paid to the broker for products or services reasonable?

## SECTION 28(E) - ELIGIBLE RESEARCH SERVICES

### Products or services related to making an investment decision

- Provide advice regarding valuation of securities, investing (buying or selling)
- Providing analysis, reports regarding securities, industries, economic indicators, sectors...
- Analytics software (including bundled with OMS – though may be considered Mixed-Use)
- Market, financial, economic data
- Corporate Access

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## SECTION 28(E) – ELIGIBLE BROKERAGE SERVICES

SEC has established a temporal standard for brokerage services. Products and services related to the execution of the trade from the point of transmitting an order to credit/delivery to the client account

### Trading / Execution platforms

- OMS/EMS used for order routing(e.g. Bloomberg AIM, MOXY) **OMS platforms may be considered Mixed-Use based on the product/features**
- Direct Market Access (DMA) systems
- Clearance, settlement, custody services
- Post trade matching and electronic communication of allocation/settlement instructions (OASYS)

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## SECTION 28(E) - INELIGIBLE SERVICES

**Does NOT Cover products & Services available to the general public on a commercial basis, such as:**

- Computers / Software – NOT involved in the analytics or trade execution process (i.e. Windows; accounting systems; databases; hardware/terminals)
- Reporting software– Including Best-Ex / TCA (post trade analytics)
- Products or services related to recordkeeping, admin, or compliance
- Marketing materials
- Trade Publications
- Telephone lines (does not include FIX connectivity)

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## SECTION 28(E) - INELIGIBLE SERVICES

### Section 28(e) - 2006 Interpretive Release No. 54165

- “Products/Services” are not automatically eligible

*“...a money manager may purchase an eligible item of research with client commissions if he or she properly uses the information in formulating an investment decision, but another money manager cannot rely on Section 28(e) to acquire the very same item if the manager does not use the item for investment decisions*

- No “pay-to-play”

*...Similarly, a money manager may not obtain eligible products, such as market data, to camouflage the payment of higher commissions to broker-dealers for ineligible services, such as shelf space or client referrals.”*

## SECTION 28(E) - MIXED-USE

Mixed-use was introduced in the 1986 Interpretive Release. It addresses products and services that include multiple functions, including those that don't qualify as either a brokerage or research under 28(e).

- Due diligence must be performed prior to service to determine qualification. Annual reviews of all services are recommended to keep mixed-use allocations up to date
- The percentage of the cost for a product or service must be allocated accordingly to either research, brokerage, both, or, N/A
- Required to keep records showing the costs allocated to 28(e) vs. internal funds

## SECTION 28(E) - MIXED-USE

### Examples of Mixed Use:

- **Trade analytics software** – Analytics may qualify as part of the trade process, but software may also be used administratively
- **Proxy voting services** – systems related to the voting process are not covered. Research related to governance and used in investment decisions are.
- **OMS** – like analytics systems, an OMS may contain trade routing, execution, allocation, etc. which would be covered.
- **Consulting services** – Consulting related to portfolio investment strategy may be covered. Consulting services related to investment manager operations would not.
- **Market research** – Market research used in investment decisions is covered. Performance reporting or evaluation is not (i.e. TCA / Execution Analysis)



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## SECTION 28(E) - MIXED-USE OMS

OMS are frequently robust systems with multiple modules and serve more than execution purposes. These examples would be considered mixed use with allocations among Research/Brokerage/Ineligible:

### **Eligible Research:**

- Pre-trade analytics related to decision making process
- Software related to market information (venues, IOI's, etc.)

### **Eligible Brokerage:**

- Connectivity between OMS and brokers (FIX)
- Post Trade software for matching/allocations (OASYS)

### **Ineligible:**

- Pre/Post Trade analytics (TCA / Best Ex)

## MIFID II

**MiFID II** - Regulation governing the requirements of investment firms, regulated markets and firms providing investment services to enhance the transparency, efficiency, and integrity of the financial markets of the EU

- Scheduled to begin Jan 3, 2018
- Traditional bundled CSA's are no longer available to use as a payment for research
- IA's must fund research budgets from their own profit and loss **OR** must use a CSA in conjunction with an RPA, controlled by the IA.

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## MIFID II - CSA / RPA

**RPA** – “Separately identifiable research charge” – Required unbundled pricing, separating research cost as well as cost for executing the trade

- Three conditions must be met for a transaction to qualify:
  1. **Funding** – Must be controlled by the IA, include a specific research charge to the client, and IA must maintain a research budget
  2. **Research Quality Assessment** – IA is responsible for the RPA account and must regularly review the quality of research to verify benefit towards investment decisions
  3. **Disclosure/Reporting** – Prior to service, IA must disclose an estimated research budget , and after, report annual costs to the client
  
- At the end of the budgeted period, any RPA funds must either be returned to the client or rolled forward to the next period

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## RESEARCH – MIFID II IN THE US

Requirements of MiFID II may conflict with Section 28(e) – Compliance may violate domestic securities law. For example:

- MiFID II - RPA accounts must be under the control of the investment firm and may be held by a third party RPA provider
- Section 28(e) – Research credits must be owned, and under the control of a registered broker-dealer
- MiFID II – Prohibits proprietary research cost to be bundled together with the cost for execution services
- U.S. Securities laws require brokers that separately invoice for research to register as Investment Advisors

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## RESEARCH – MIFID II IN THE US

### SEC Press Release

October 26, 2017

The Division of Investment Management provided **temporary relief for thirty (30) months from MiFID II's implementation date** under the Investment Advisers Act of 1940 ("Advisers Act")

*“The no-action relief provides a path for market participants to comply with the research requirements of MiFID II in a manner that is consistent with the U.S. federal securities laws. More specifically, and subject to various terms and conditions:*

### “Substantially Equivalent” MiFID II Compliance

1. Set a budget for research costs. Provide a policy on use
2. Account for the research received/commissions paid
3. Create policies/procedures to prevent conflict of interest

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## DIRECTED BROKERAGE

Directed Brokerage – Plan Sponsor requests the money manager to direct commission business to a particular broker/dealer, who has agreed to provide services, pay obligations, or make cash rebates to the plan (i.e. Commission Recapture Plan), effectively reducing the commission rate paid by the plan

- Subject to best execution
- Does NOT fall under 28(e) – is not considered either research or brokerage services
- 28(e) applies ONLY when exercising investment discretion
- The DOL has indicated that if the rebate, goods or services provided by the broker to the plan is not for a purpose that exclusively benefits the plan, the transaction would constitute a violation of ERISA
- Directed Brokerage benefiting other than the plan could also be a violation of the Investment Company Act of 1940

## FRAMEWORK FOR POLICIES & PROCEDURES

**Implement a policy based on statutory, contractual, and fiduciary requirements, as well as industry best practice**

### **THERE IS NO ONE SIZE FITS ALL!**

- Adopt formal written policies and procedures
- Create a committee to perform due diligence and review of approved brokerage relationships
- Maintain books and records
- Monitor the trade process through Trade Cost Analysis reports
- Disclose to clients and prospects any possible conflict of interest\
- Periodically and systematically evaluate execution performance of broker/dealers executing transactions

## BROKERAGE COMMITTEE

- Performs due diligence on any new broker relationships and has a formal approval process
- Qualify product or service meets definition of research, brokerage, or mixed-use
- Determine whether products or services are reasonable value
- Performs regular reviews of both client commission arrangements and products and services provided
- Documents any changes to broker list or products and services provided



## MAINTAIN BOOKS & RECORDS

### Investment Advisors Act of 1940 Act

***Rule 204-2 “IA is required to keep accurate, current books and records related to the advisory business. In the case of securities transactions, particularly those which may involve soft dollars, the advisor’s books and records should contain sufficient details relating to each participant transaction.”***

\*Managers are required to maintain books and records in an easily accessible place for five years, with two years within the office of the manager.

## MAINTAIN BOOKS & RECORDS

**Advisor 's brokerage committee should document and maintain:**

- Due diligence documentation, evaluation of brokerage arrangements
- Contracts or written agreements
- Approved broker list and any client commission arrangements provided
- List and description of products and services provided by brokers
- Annual commitment or commission ratio
- List of any mixed use services allocations between soft/hard dollars
- Soft dollar budgets/reporting
- TCA / Best Execution
- Policies and procedures

## MAINTAIN BOOKS & RECORDS

**Transaction record retention should include:**

- Trade tickets
- Confirms
- Brokerage statements

**These the items will reflect:**

- Discretionary authority
- Principal or Agency execution
- Aggregation of orders
- Allocation of shares
- Trade rotation
- Commissions paid

**Demonstrates a policy of uniform treatment of accounts with no preferential treatment**

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## MONITORING THE TRADE PROCESS - NBBO

SEC Rule 605 – Reg NMS – Requires market centers that trade NMS securities to make monthly reports regarding the quality of execution on a stock by stock basis.

- Order type (five types)
- Order size (four tiers - \*up to 9,999 shares)
- Spreads
- Rate of price improvement/dis-improvement
- Fill Rates
- Speed of execution

\* **Designed more for a retail type client**

## MONITORING THE TRADE PROCESS - NBBO

SEC Rule 606 – Reg NMS – Requires broker-dealers routing non-directed orders to provide reporting on:

- Top 10 venues orders are routed
- Venues receiving more than 5% of broker orders
- Disclosure of any payment arrangement between venue and broker for order flow

## MONITORING THE TRADE PROCESS - TCA

Trade Cost Analysis Reporting – Broker provided execution analysis including metrics comparing implicit cost and explicit cost to industry statistics including:

- Broker/execution venue used
- Commission cost
- Fees
- Execution cost vs. various metrics (i.e. VWAP, implementation shortfall, etc.)
- Total execution costs
- Compared vs industry statistics

## MONITORING THE TRADE PROCESS

- Execution analysis should be done systematically and periodically (monthly/quarterly/annually), reviewing performance of executing broker-dealers
- Reviews/reporting should be produced both internally and externally
- Soft dollar budgets should be maintained and reviewed along with execution analysis
- Monitoring/Reporting of best execution is NOT 28(e) eligible

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## DISCLOSURES

### Investment Company Act 1940 – Rule 206(4)-7

*...adviser's policies and procedures, at a minimum, should address...Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients*

#### - Investment Advisory Agreement

##### - Form ADV Part II:

- **Item 8** – Disclosure of whether advisor receives products/services other than execution from a broker
- **Item 12** - Brokerage Practices – Requires disclosure to clients regarding investment of brokerage discretion

#### -Form N-1A (Funds) Registration Statement

- **Part B - Item 21** – Brokerage Allocation and Other Practices



## CONCLUSIONS

- Best execution is not specifically defined. It entails a fiduciary responsibility to seek the best quantitative AND qualitative execution for the client
- Lowest commission and spread do NOT equate best execution
- Orders need to be evaluated on the best suited broker to use
- Brokers need to be evaluated on the value of the services they provide vs cost of transactions
- Best execution incorporates the safe harbor of Section 28(e) to achieve these ideas
- Managers are required to conduct due diligence, provide disclosure, and monitor their brokerage use.
- Best Execution constantly evolving with the industry and regulatory landscape

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## ADDITIONAL RESOURCES

### ***SEC - 1986 Interpretive Release***

*<https://www.sec.gov/rules/interp/34-23170.pdf>*

### ***SEC - 2006 Interpretive Release***

*<https://www.sec.gov/rules/interp/2006/34-54165.pdf>*

### ***SEC - Division of Investment Management***

*<http://www.sec.gov/divisions/investment.shtml>*

### ***SEC – Information for New Investment Advisors***

*<http://www.sec.gov/divisions/investment/advoverview.htm>*

### ***SEC – Press Release 2017 – Implementation of EU MiFID II Research Provisions***

*<https://www.sec.gov/news/press-release/2017-200-0>*

### ***FINRA – Examination Findings Report – Best Execution 2017***

*<http://www.finra.org/industry/2017-report-exam-findings/best-execution>*

### ***FINRA – Regulatory Notice 15-46 – Best Execution Guidance***

*[https://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Notice\\_Regulatory\\_15-46.pdf](https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf)*

## QUESTIONS?

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